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C O N F I D E N T I A L SECTION 01 OF 03 BEIJING 003895

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E.O. 12958: DECL: 06/08/2032
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SUBJECT: CONTACTS CITE LEADERSHIP CONCERNS OVER FUTURE
STOCK MARKET DOWNTURN

REF: SHANGHAI 325

Classified By: Acting Political Minister Counselor
Robert Griffiths. Reasons 1.4 (b/d).

Summary

11. (C) While Chinese across the country continue to obsess over the latest moves of the Shanghai and Shenzhen bourses (reftel), Beijing contacts caution that frenzied stock market investment (over 100 million Chinese hold shares as of early June) is an increasing concern for Beijing's leaders. Despite several small protests following the recent stamp tax hike, Beijing contacts we spoke with do not believe that stock market fluctuations will present a major political stability challenge in the short term and economists do not believe a sharp drop in stocks will significantly threaten overall economic performance. The leadership is clearly concerned, however, over the potential political stability impact of a serious market downturn, especially given that some investors have put their life savings at risk or even borrowed illegally in order to ride the equity wave. Contacts assessed that some retail investors are overextending themselves on the bet that the Government will work hard to keep the markets from tanking through important upcoming events, especially the August 2008 Beijing Olympics. One scholar noted the irony of the situation, commenting that "the people have taken the Government hostage and is making it pay ransom." If the bubble bursts and some retail investors are wiped out, they will blame the Government, contacts agreed. End summary.

Hot Stocks and Everybody's In

12. (C) The Shanghai and Shenzhen stock markets have ballooned in the last few months with the Shanghai market up about 45 percent this year as tens of millions of middle class Chinese have gotten into the game to reap the gains of the stock craze. Almost seven million new investor accounts were opened in April and more than nine million were opened in May, according to official statistics, although many of these may be multiple accounts. Beijing contacts, from officials to academics to businesspeople, commented that playing the stock markets is the latest addiction for Chinese of all ages and social strata. One software technician said that her officemates no longer work, they stare at computer screens and trade stocks all day. Everbright Bank official Li Jie complained that people have "gone crazy," pulling their savings out of banks, selling cars, homes and

applying for false mortgages in order to put money into the market. In a wry response to an online article that expressed concern about people spending their social security to buy stocks, one netizen wrote, "that's nothing, don't you know that people are pawning their underwear?"

13. (C) While it is hard to pinpoint the extent to which those entering the markets can afford it, contacts pointed to the plethora of new accounts, the sheer number of those now involved in the market (estimated at over 100 million Chinese) and their personal knowledge of specific high risk behavior to conclude that a fairly large group is dangerously leveraged and will not be able to absorb a downturn. Lawyer Wang Xuelan told Poloff that recently, instead of gathering in the park near her home to do tai chi exercises, retired people are gathering in day trading offices around computer screens where they discuss stock trades all day. "They gather in large groups on the first floor, where the very public terminals are," she said. "They can't afford the more private spaces on the second floor." People's University professor Zhang Xiaojin (protect) said his students were following the markets so closely that when the bourses dropped on May 31, the line at the campus bank, where market transactions are made, extended around the building in the minutes after trading opened.

The Dukes of Moral Hazard

14. (C) Not only can many of those who are getting in not afford to lose, most are aware that many of the

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stocks they are buying are not backed up by real assets, commented banker Li. (Comment: While many companies traded on the exchanges may have weak corporate governance, the most popular stocks are those of well known companies with prospects for future profitability such as China Life, Bank of China, Sinopec and Baosteel. End comment.) Global Times journalist Wang Wen said, "Everyone knows this is not a market, it's a policy, so they believe that quality is not relevant."

15. (C) The extent to which investors believe the Government is responsible for market movements was reflected in popular anger over the May 30 stamp tax hike and the subsequent dip in the market. Small groups of protesters gathered at the Ministry of Finance in Beijing on June 1 and subsequently at a securities firm in Shanghai. While these incidents were not viewed as serious stability threats (the protest at the Ministry of Finance was derided by one journalism professor, who commented that "everyone knows MOF is not even involved in stock market regulation"), they indicate that people are quick to take their complaints over stock losses to the Government. One contact expressed anguish to Congenoff that the Government "had lied" in stating that it would not increase the stamp tax right up until the eve of the change.

Taking the Government Hostage?

16. (C) Many of our contacts felt that the Government would be able to handle political instability resulting from economic fluctuations in the near term, but worried about what might happen in the mid and longer term. Dissident writer Wang Lixiong called the stock market the Chinese Government's "blind spot." "The people have taken the Government hostage and are making it pay ransom," he said. The Olympics is an

important break point that everyone has identified, he said. Most people believe they will be able to pull their money out before a market collapse, but some people will clearly get hurt. Those people, Wang asserted, will be the people who are overleveraged and have little recourse, a sentiment that was shared by other contacts. A Beijing stockbroker's recent comment to an Amciti businessperson here that "of course people are going to get hurt, but it's not going to be me" is representative of investor attitudes in general, contacts reported.

17. (C) A market downturn concerns the Government because the market losers in this scenario are precisely those who would be prone to take to the streets in protest, banker Li and author Wang separately stated. While the Government is determined to handle market fluctuations in the short-term, the political stability consequences of a future major downturn are unpredictable. Pointing to media efforts over the last few days to educate stockholders about the risks of investing, free lance journalist Chen Jieren judged that the Government will step up efforts to prepare the population for market dips. This will be difficult, however, he predicted, since many Chinese believe they have insider knowledge that will protect them from market surprises. "Frankly, if you're not insider trading in this market, you'd best not be trading at all," one young securities lawyer quipped to Poloff.

Economic Fundamentals Still Strong

18. (C) Our economic contacts who follow the stock market are uniform in pointing out several factors that would mitigate the economic impact of any significant near-term stock market downturn. First, stocks are still not a large part of household wealth in China; one estimate we received suggests that actual tradable shares make up approximately 11% of direct financial holdings (money, stocks, and bonds) - or, measured another way, approximately 22.5% of GDP -- suggesting that a 30% downturn would only lead to a fractional decline in household assets and economic activity. Second, the stock market gains have come quickly and have by and large not yet been spent, indicating that investors believe much of the gains to date are transient. Third, there have been several recent instances of the market falling dramatically in

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one day and then rising again quickly; this suggests that people are not being forced to sell shares to cover losses, i.e., that most holders of stock have funded their purchases with their own savings rather than through borrowing and are able to ride the ups and downs of the market. Finally, most analysts believe that China's economic fundamentals are still strong and are forecasting continued high growth of household income and corporate profitability.

But Prospect of Angry Investors Unnerves

19. (C) Taken together, these factors suggest that a significant downward slide may have a less dramatic impact on political stability and economic growth than feared. That said any sizable decline would likely create financial hardship for a measurable subset of new investors. The resulting stories of leveraged stockholders losing their shirts and scandals surrounding windfall gains for corrupt officials, unseemly fund managers or poorly-run corporations would likely lead to widespread anger and protests. How widespread is impossible to predict, but it is a

question that is reportedly being taken very seriously
in the Chinese leadership.

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